DVARA Research

Note on RBI's Prompt Corrective Action Framework for Non-Banking Financial Companies

-*Sowmini G Prasad & Dwijaraj Bhattacharya*

2022

DVARA Research

Contents

Background 3
Summary of the PCA Framework 3
The Inclusion Error 4
False Equivalence between NBFCs and Banks 5
The Exclusion Error 6
An Incomplete Remedy to Address Risks 6
Retail Depositor Protection 6
Resolution Mechanism 7
Conclusion 9

DVARA Research

Background

The new financial year has ushered in many changes for Non-Banking Financial Companies (NBFCs). On the one hand, NBFCs will be regulated under the Reserve Bank of India's (RBI) new Scale Based Regulations (SBR), while on the other, the RBI has proposed the introduction of the Prompt Corrective Action (PCA) framework for NBFCs, both due to come into effect from October 1, 2022[1].

On December 14, 2021, citing the growing size and interconnectedness of NBFCs, the RBI proposed implementing the PCA framework based on the financial position of NBFCs on or after March 31, 2022[2]. In this note, we discuss how the current approach of the PCA framework is inconsistent with the objectives it seeks to achieve. This inconsistency arises due to two critical errors as we see it – inclusion and exclusion. The inclusion of smaller NBFCs, which do not pose any threat to the stability of the financial system, leads to a misutilisation of the RBI's supervisory capacity. Further, the inclusion error also implies a false equivalence between banks and NBFCs. The exclusion error manifests since the RBI has left large and interconnected Housing Finance Companies (HFCs) outside the scope of the PCA framework. Finally, we argue that the PCA framework alone is an incomplete remedy to address risks originating from the NBFC sector. Before discussing these issues in detail, we present a summary of the PCA framework in the next section.

Summary of the PCA Framework

The PCA framework applies to all deposit-taking NBFCs (NBFCs-D) and all non-deposit taking NBFCs (NBFCs-ND) in the Middle, Upper, and Top Layers, identified under RBI's new SBR[3]. It excludes NBFCs not accepting/not intending to accept public funds, Government Companies, Primary Dealers, and Housing Finance Companies (HFCs).

The PCA framework is intended to act both as a supervisory tool and a tool for effective market discipline to restore the financial health of the supervised entity in question. It proposes to track the following indicators across three key areas – capital, asset quality, and leverage (only for Core Investment Companies (CICs)).

Table 1: List of Indicators and their Applicability under the PCA Framework

NBFC Category	Indicator 1	Indicator 2	Indicator 3
For NBFCs-D and NBFCs-ND (excluding CICs)	Capital to Risk-Weighted Assets Ratio (CRAR)	Tier I Capital Ratio	Net Non-Performing Asset (NNPA) Ratio (including Non-Performing Investments (NPIs))
For CICs	Adjusted Net Worth / Aggregate Risk-Weighted Assets	Leverage Ratio	NNPA Ratio (including NPIs)

[1] See 'Prompt Corrective Action (PCA) Framework for Non-Banking Financial Companies (NBFCs)', December 14, 2021, Reserve Bank of India, https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12208&Mode=0

[2] *ibid*

[3] See 'Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs', October 22, 2021, Reserve Bank of India, https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12179&Mode=0

DVARA Research

There are three graded risk thresholds for each of the above indicators, and breach of any of these thresholds will result in invocation of corrective actions under the PCA framework. These corrective actions include both mandatory and discretionary actions that the RBI may prescribe. Mandatory actions are based on the risk threshold breached and are incremental. Therefore, an NBFC breaching Risk Threshold-2 would have to face the set of actions applicable to Risk Threshold-1 and -2[4]. Discretionary actions are common to all three key areas and risk thresholds.

The application of the PCA framework to all NBFCs-D and NBFCs-ND in the Middle, Upper, and Top Layers, appears to be driven by two objectives- a) systemic stability and b) protection of term depositors of NBFCs (many of whom are retail)[5]. However, upon a closer study of the PCA framework, concerns around the efficacy of the current approach emerge. These concerns have been discussed in the sections that follow.

The Inclusion Error

As discussed earlier, the PCA framework applies to all NBFCs-ND in the Middle, Upper, and Top Layers under the SBR framework. To recapitulate briefly, NBFCs in the Middle Layer (NBFCs-ML) will consist of NBFCs-ND with an asset size of Rs. 1000 crore (Cr) and above. The NBFCs in the Upper Layer (NBFCs-UL) will comprise NBFCs-ND, which the RBI specifically identifies as warranting enhanced regulatory requirements. The classification into the NBFCs-UL will be based on a scoring methodology provided in the SBR framework. The Top Layer is expected to be empty and can get populated if the RBI believes there is a substantial increase in the potential systemic risk from specific NBFCs-UL[6].

The RBI's discussion paper which outlined the SBR framework, suggests that the RBI had drawn a clear distinction between NBFCs-ML and NBFCs-UL. The discussion paper suggests that the scoring methodology in the SBR framework is intended to help RBI identify those NBFCs-ND which are *systemically significant*, i.e., with a *large potential of systemic spill-over risks and having the ability to impact financial stability*. However, in the case of NBFCs-ML, RBI's concerns seem limited to *the potential of systemic risk spill-overs*[7].

---

[4] The risk thresholds are discussed in detail for the indicator "NNPA Ratio" in Table-2.
[5] All references to retail depositors in this note refer to retail term depositors of deposit taking NBFCs (NBFCs-D) and housing finance companies (HFCs) which have permissions to accept such deposits from retail customers.

While the RBI does not state these explicitly as being the objectives behind introducing the PCA framework, the guidelines suggest the same in the following manner – a) In the guidelines, RBI states that "NBFCs have been growing in size and have substantial interconnectedness with other segments of the financial system. Accordingly, it has now been decided to put in place a PCA Framework for NBFCs to further strengthen the supervisory tools applicable to NBFCs". This suggests concerns over systemic stability that can be triggered upon failure of NBFCs, and b) RBI's decision to apply the PCA framework to all NBFCs-D irrespective of their asset size indicates a concern for retail depositor protection. This is in line with RBI's motivation behind harmonising the regulatory framework for systemically important non-deposit taking NBFCs (NBFC-ND-SI) and NBFCs-D. A similar approach has also been evidently adopted by the RBI in its new SBR framework where NBFCs-D D are proposed to be treated on par with systemically important NBFCs since they can only be regulated as Middle Layer NBFCs or above.
See Paragraph 16, Page 6 of the speech delivered by Mr. R. Gandhi (the then Deputy Governor, RBI) on 23 November 2014, https://www.bis.org/review/r141124h.pdf
[6] See 'Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs', October 22, 2021, Reserve Bank of India, https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12179&Mode=0.
[7] See Section 3.3 – Introducing Scale-based Framework, 'Discussion Paper on Revised Regulatory Framework for NBFCs - A Scale-Based Approach', January 22, 2021, Reserve Bank of India, https://www.rbi.org.in/Scripts/PublicationsView.aspx?id=20316#CH3

Given the RBI's tacit position that NBFCs in the Middle Layer are not as risky or interconnected as their counterparts in the Upper Layer, the decision to supervise NBFCs-ML under the PCA framework appears to be inconsistent with the framework's objectives. An NBFC with an asset size of Rs. 1100 Cr is unlikely to destabilise the Indian banking system, which has total assets of Rs. 237 lakh Cr (excluding cooperative banks)[8]. Thus, the imposition of the PCA framework on NBFCs-ML appears to be a misplaced use of RBI's supervisory capacity. However, not all NBFCs are alike. NBFCs-UL do pose systemic risk, and thus we agree with RBI's approach that such NBFCs should be supervised under the PCA framework.

Further, the decision to cover NBFCs-ML under the PCA framework is at odds with the optimal design of credit ecosystems. In India, NBFCs are well-positioned to take on risks that banks cannot and must not. Given NBFCs' asset-class specialisation and access to superior information about borrowers, they are well-suited to offer credit to niche customer segments. A large pool of NBFCs operating on the periphery of the banking system can help expand the real economy's access to credit in an orderly manner. However, at the same time, this risky periphery should surround a safer core formed by banks. Thus, we posit that the RBI should instead focus its supervisory capacity on banks occupying the core of the credit ecosystem and the larger and riskier entities in the periphery, i.e., NBFCs belonging to the Upper and Top Layers.

False Equivalence between NBFCs and Banks

The graded risk thresholds for the asset quality indicator in the case of both banks and NBFCs are similar, as shown in Table 2. Further, the RBI's mandatory and discretionary actions to address credit risk concerns are also similar[9]. Thus, it appears that the RBI is drawing a parallel between NBFCs and banks. However, such parallels are false. The capital adequacy requirements, which translate into the risk absorption capacity of banks and NBFCs, are different. More importantly, a bank *creates* money when it issues credit, while an NBFC only *on-lends* funds, and as such, an NBFC resembles a real-sector entity more than it resembles a bank. Apart from the false equivalence drawn between banks and NBFCs, the uniform application of risk thresholds for NBFCs in the Middle, Upper and Top Layers also leads to a false parallel between these entities, thus obfuscating the difference in risk that an NBFC in the Upper Layer poses when compared with an NBFC in the Top Layer. An NBFC-ND with Rs. 4000 Cr asset size and an NNPA ratio of 11% poses a much lesser risk to depositor-monies (and hence the invoking of RBI's LOLR functions) than a bank of the same size and NNPA ratio.

Table 2: Risk Thresholds for NNPA Ratio

Entity Type	Risk Threshold-1	Risk Threshold-2	Risk Threshold-3
For NBFCs-D and NBFCs-ND (including CICs)	>6% but ≤ 9%	>9% but ≤12%	>12%
Scheduled Commercial Banks (excluding SFBs, PBs, and RRBs)	>=6.0% but <9.0%	>=9.0% but < 12.0%	>=12.0%

[8] This figure is as of March 31, 2021. Assets of cooperative banks as of March 31, 2020, totalled to Rs. 19 lakh Cr. See 'Report on Trends and Progress of Banking in India 2020-21', December 2021, Reserve Bank of India, https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0RTP2020CF9C9E7D1DE44B1686906D7E3EF36F13.PDF

[9] See 'Prompt Corrective Action (PCA) Framework for Scheduled Commercial Banks', November 02, 2021, Reserve Bank of India, https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12186&Mode=0

Apart from the inclusion error, whereby the RBI has included smaller NBFCs under the PCA framework, the current approach of excluding HFCs also results in an exclusion error.

The Exclusion Error

The PCA framework does not apply to HFCs, and it is not clear why they should not be supervised at par with NBFCs. At the end of March 2021, there were 100 HFCs, of which 16 were deposit-taking entities[10], and the asset size of 37 HFCs was more than Rs. 1000 Cr[11] - the threshold beyond which NBFCs are identified as systemically important under the SBR framework for enhanced regulation[12]. Additionally, as of September 2021, HFCs were the second largest receiver of funds after non-HFC NBFCs in the financial system, and the potential contagion losses to the banking system from the failure of HFCs have been estimated to be much higher than non-HFC NBFCs[13]. Therefore, given the prominence of HFCs in the financial system and the potential risk they can pose to both systemic stability and retail depositors upon their failure, it is not clear why the supervisory processes under the PCA framework should not apply to HFCs.

Further, the supervisory approach for HFCs is inconsistent with the regulatory approach the RBI has adopted since regulatory powers were transferred from the National Housing Bank in 2019. Since then, the RBI has issued guidelines aligning the regulatory framework for HFCs with that of NBFCs and the former are now considered an NBFC category[14]. In adopting this regulatory approach, the RBI has explicitly cited the need to ensure a sound and resilient housing finance sector and the need to protect the interests of depositors and investors, all of which align with the objectives of the PCA framework[15]. Therefore, we argue that HFCs meeting the qualifying criteria for NBFCs-UL should also be brought under the PCA framework. However, even if the RBI includes HFCs, there may remain other risks that the PCA framework is unable to mitigate; these are discussed in the next section.

An Incomplete Remedy to Address Risks

Retail Depositor Protection

The protection of term depositors of NBFCs appears to be the implicit intent of RBI in applying the PCA framework to all NBFCs-D, irrespective of their asset size. While we welcome this move, the PCA framework can only be viewed as an incomplete remedy. NBFCs-ND, which access public money through listed debt, are required to adhere to a more stringent public disclosure regime mandated by

---

[10] See Page 150, 'Report on Trends and Progress of Banking in India 2020-21', December 2021, Reserve Bank of India, https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0RTP2020CF9C9E7D1DE44B1686906D7E3EF36F13.PDF
[11] See 'Companies (HFCs) with asset size of ₹100 Cr & above as on 31-03-2021', National Housing Board, https://nhb.org.in/wp-content/uploads/2021/08/asset-size-31-03-2021-100cr-above.pdf
[12] See 'Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs', October 22, 2021, Reserve Bank of India, https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12179&Mode=0.
[13] As at end-Sep 2021, NBFCs had the largest net payables to the financial system at Rs. 10.41 lakh Cr followed by HFCs at Rs. 6.77 lakh Cr. This includes borrowings from SCBs. By end-September 2021, idiosyncratic failure of the NBFC or HFC with the maximum capacity to cause solvency losses to the banking system would have impacted banks' total Tier-1 capital by 2.28% and 6.43%, respectively.
See Pages 76-78, 'Financial Stability Report', Issue No. 24, December 2021, Reserve Bank of India, https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/FSRDEC2021_FULL2D99E6548CD0478CA90EE717F2B85D45.PDF
[14] See Page 36, 'Report on Trends and Progress of Banking in India 2020-21', December 2021, Reserve Bank of India, https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0RTP2020CF9C9E7D1DE44B1686906D7E3EF36F13.PDF
[15] See Page 4, 'Report on Trends and Progress of Banking in India 2018-19', December 2019, Reserve Bank of India, https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0RTP241219FL760D9F69321B47988DE44D68D9217A7E.PDF
Also see 'Master Direction – Non-Banking Financial Company – Housing Finance Company (Reserve Bank) Directions, 2021', December 28, 2021, Reserve Bank of India, https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12030

both the RBI and the Securities and Exchange Board of India (SEBI) compared to NBFCs-D that do not list. It is not clear why regulatory treatment of unlisted NBFCs-D should be any different from NBFCs-ND with listed debt since the risks that retail customers are exposed to are similar between retail term deposits and listed Non-Convertible Debentures (NCD)[16].

For NBFC-Ds, which do issue listed debt, one may argue that in such cases, there is a parity between the disclosures available to the retail (term) depositor and the investor in the listed debt. However, such parity often does not materialise. SEBI specifies the mechanism through which such information is to reach the investors — through the stock exchange or direct dissemination to the security holders[17]. Thus, it is possible that even for a listed D-NBFC, the retail debt investor has access to more information due to the targeted dissemination compared to the retail (term) depositor.

Therefore, to truly achieve retail depositor protection, the RBI should ensure that the degree of transparency available to investors of listed debt becomes available to term depositors in NBFCs. In the long run, however, RBI should consider phasing out the license for NBFCs-D as there is no need for a separate NBFC license with permission to accept retail deposits[18]. The RBI's inaction in terms of not issuing any new NBFC-D license since 1997 appears to indicate it is in tacit agreement that the potential harms associated with NBFCs-D outweigh the benefits of having the separate regulatory carve-out for such entities. Thus, the current approach is an incomplete remedy in regard to the objective of term depositor protection.

Resolution Mechanism

The key to ensuring that the PCA framework successfully safeguards the financial system, and its participants, is to have a robust resolution framework. Currently, the resolution of NBFCs is done according to the Insolvency and Bankruptcy Code (IBC). This applies to all NBFCs with asset sizes above Rs. 500 Cr. This approach is adequate for NBFCs in the Base and Middle Layers. However, NBFCs-D and NBFCs in the Upper and Top Layers need to be resolved differently.

Given that NBFCs-D accept public (term) deposits, their failure would put retail depositors at great risk since other financial creditors may force unequal haircuts on the retail depositors compared to other unsecured creditors. This case is discussed in detail in the following paragraphs using the example of the only discharged NBFC under the IBC. NBFCs-UL and NBFCs in the Top Layer would have significant interconnectedness, leading to high contagion risk. Also, unlike real sector firms, the assets of financial firms lose value quickly once resolution proceedings begin. Thus, to effectively protect the interests of retail depositors and to minimise systemic risk, the resolution of these firms needs to be quick and must happen while the firm is not yet fully insolvent.

The proposed PCA framework enables the RBI to monitor the health of NBFCs closely, allowing it to promptly refer the entity for resolution under the IBC, even before it defaults. Thus, it may appear that the concern around the necessity of the resolution before an NBFC turns insolvent is currently

[16] Retail term deposits are akin to listed Non-Convertible Debentures (NCD) issued by any corporate in that they are not callable on demand by the depositor.

[17] SEBI Listing Obligations and Disclosure Requirements Regulations, 2015

[18] See Section C, 'Reimagining India's Approach to NBFCs', Regulatory and Supervisory Approaches for NBFCs, Dvara Research, March 2021, https://www.dvara.com/research/wp-content/uploads/2021/03/Regulatory-and-Supervisory-Approaches-for-NBFCs.pdf

addressed. However, concerns of quicker turnaround and, more importantly, maximising the value of the NBFC remain.

The IBC has been notorious for delays when it comes to larger resolution processes. Currently, 73% of cases are not resolved within the stipulated resolution period of 270 days[19]. In the case of NBFCs, the data is sparse. The only resolved NBFC under the IBC is Dewan Housing Finance Corporation Limited (DHFL). On Nov 20, 2019, the RBI had superseded DHFL's board, and on December 3, 2019, the resolution process against DHFL started[20]. After one and a half years, i.e., after twice the time stipulated for resolution, on June 7, 2021, the resolution plan was approved[21]. However, several key aspects of the resolution plan, including the haircuts prescribed for the depositors, continue to remain sub-judice[22].

Retail depositors of the erstwhile NBFC-D, DHFL, were posited to receive only 23% of their admitted claims, translating into a haircut of 77%[23]. At the same time, other financial creditors had to suffer a haircut of 60%[24]. These haircuts and other sub-judice aspects of the resolution plan indicate that the current IBC process is sub-optimal. Instead, we propose the adoption of the recommendations of the Financial Sector Legislative Reforms Commission (FSLRC).

FLSRC had recommended that a singular and separate resolution framework be created for financial firms. Under the framework, it had recommended the formulation of a Resolution Corporation (RC), which would monitor the health of all financial firms and rate them according to their risk of failure using a matrix similar to the PCA framework proposed by the RBI[25]. When the risk of failure of a firm crosses a threshold, the RC would take over the firm in coordination with the concerned regulator and try to resolve the firm as quickly and efficiently as possible.

With the introduction of the PCA framework, a framework is now in place to monitor the health of NBFCs. However, several other benefits continue to exist under the FSLRC approach. One, as mentioned earlier, the RC would be characterised by the speed of its actions, essential to the resolution of financial firms. Further, under the risk matrix proposed by the FSLRC, steps aimed at resolution would be initiated upon an entity breaching a specific risk threshold, whereas, under the PCA framework, resolution is a discretionary action that the RBI may initiate. This can potentially lead to regulatory forbearance. Two, protecting customers' interests would form one of the key considerations in RC's approach to resolution. Therefore, in the specific case of NBFCs, retail (term) depositors, who often unwittingly tend to assume higher risks than sophisticated financial creditors, like banks, would be prioritised based on an assessment made by the RC[26]. This is not to say that (term) depositors of NBFCs should be given priority over unsecured institutional lenders, but that retail

---

[19]See Figure 11, page 14, 'The Quarterly Newsletter of the Insolvency and Bankruptcy Board of India, October-December 2021', https://www.ibbi.gov.in/uploads/publication/f93d15cd01db076d3ff7931450acb4bd.pdf

[20] See NCLT Order dated June 07, 2021, regarding DHFL v COC, reference: CP(IB)No. 4258/MB/C-II/2019, https://www.ibbi.gov.in/uploads/order/4dc4028ccc12768a83b5726399fc8698.pdf

[21] *ibid*

[22]See 'DHFL resolution: Fixed deposits holders move Supreme Court', March 16, 2022, The Hindu Business Line, https://www.thehindubusinessline.com/money-and-banking/dhfl-resolution-fixed-deposits-holders-move-supreme-court/article65227050.ece

[23]*ibid*

[24] *ibid*

[25] See Chapter 7, Volume I: Analysis and Recommendations, Report of the FSLRC, March 2013, https://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf

[26] See Pages 71 and 72, Chapter 7, Volume I: Analysis and Recommendations, Report of the FSLRC, March 2013, https://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf

depositors will not be penalised unfairly, as discussed in the case of DHFL earlier. Finally, under a singular RC, the assets of all NBFCs referred for resolution will be administered by a single entity (along with the assets of other financial firms). This enables both economies of scale and scope and is likely to enhance the efficacy of the resolution process[27,28].

Conclusion

Concerns around systemic stability and retail depositor protection appear to be the motivating factors behind RBI's decision to introduce a PCA framework for NBFCs. However, the current approach of the PCA framework is inconsistent with achieving these objectives, as reflected in its decision to - a) apply the PCA framework to NBFCs-ML, which are not systemically significant, and b) exclude HFCs entirely from the PCA framework. Additionally, the PCA framework is likely to be an incomplete remedy in addressing the two concerns, given the inadequate disclosure regime governing NBFCs-D and the lack of a robust resolution mechanism, especially for NBFCs-D NBFCs-UL and NBFCs in the Top Layer.

[27] See Section 5 of '*Bank failure management in the European banking union: What's wrong and how to fix it',* Restoy et. al., Occasional Paper-15, Financial Stability Institute, Bank of International Settlement; https://www.bis.org/fsi/fsipapers15.pdf

[28] See 'The Report of the Working Group on Resolution Regime for Financial Institutions', The Reserve Bank of India, 2014, https://dea.gov.in/sites/default/files/Report%20of%20the%20Working%20Group%20on%20Resolution%20Regime%20for%20Financial%20Institutions%20.pdf